University of Mississippi
eGrove

Haskins and Sells Publications | Deloitte Collection

1924

# Reports of two kinds

Anonymous

Follow this and additional works at: https://egrove.olemiss.edu/dl_hs

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation
Haskins & Sells Bulletin, Vol. 07, no. 09 (1924 September), p. 67-69

This Article is brought to you for free and open access by the Deloitte Collection at eGrove. It has been accepted for inclusion in Haskins and Sells Publications by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

The following is a typical case; a certain bookkeeper and cashier was suspected of irregularities. We were retained to make an investigation. We discovered that he had been misappropriating receipts from customers and funds already in possession of the company through excessive pay roll charges. The shortage which could be definitely established was $1,236.43. He was suspected of further misappropriations which could not be positively determined because of the condition of the records.

The report contains eighteen pages of text and seventeen pages of exhibits. It opens with the usual presentation referring to the comments and describes five exhibits relating to invoices and time cards. The presentation makes no mention of the shortage either in fact or amount, merely reciting the authority for and specific nature of the engagement. The comments begin with a discussion of the records examined, followed by a discussion of the cash book, the condition of the records, irregularities, the classes of irregularities, after which the irregularities are itemized and described in detail. Not until one reaches page nine of the report is it possible to determine the total of the irregularities of definite amounts.

Ordinary every day common sense, to say nothing of business psychology, would suggest that the thought uppermost in the mind of the client upon receiving the report and the question which probably he would ask were he to have the opportunity would be, "How much is he short?" He might be excused for being peeved if his question were not answered or the answer were not forthcoming promptly.

His question would have been answered and the chances are that his impression of our ability would have been better, if in the presentation after the usual introduction, "Pursuant to engagement, etc.," we had set forth the results somewhat in the following fashion:

"Our investigation discloses misappropriations of cash amounting to $1,236.43, in addition to which there are numerous alterations in the accounts which create the suspicion of irregularities without affording definite evidence of misappropriation. The determination of specific amounts in these instances appears to be impossible because of the chaotic condition of the records kept by Mr. Blank. Our findings in detail are set forth in the sixteen pages of comments and the following described exhibits."

Every investigation calls for an expression of findings. The findings should be summarized as near the beginning of the report as possible. Gist is the thing of importance. Amplification and elaboration may follow. The thing of importance should occupy the prominent place. Answering questions should not be a lost art.

## Reports of Two Kinds

AUDIT reports may be classified, for the purpose of considering their practical value to clients, into two kinds. In one, the comments are devoted chiefly to a discussion of the audit procedure. In the other, the discussion covers rather the significance of the accounting results as reviewed by the auditor after he has verified their accuracy, the reliability of their sources and the soundness of the processes by which they were developed.

Comments of the first kind fill many pages. They give the report an appearance of having quantity. If quantity is the standard by which reports are judged such reports are successful. Comments of this character require considerable time for their preparation, typing and review, not to mention the paper involved. Their value to the client is extremely doubtful, particularly when one considers the minute detail into which they go.

That the client may be interested in certain matters of procedure or of fact must be conceded. A specific request on his part for a detailed examination of the cash transactions obviously calls for a definite statement in the comments that this was done, with whatever the result may have been. It is conceivable that he may be interested in the announcement that requests for confirmation of accounts receivable were sent to all customers with the result that satisfactory replies were received from 85 per cent. He is unlike the average man if he is willing to pay for a formal recital of the methods which the auditor used to satisfy himself on every account and an explanation of all the items in the financal statements which either have been or could be made entirely clear in the captions thereof.

On the other hand information which may be used to advantage in "running the business" usually is welcome. Frequently it is worth to the client many times what it cost him to obtain. The audit is unusual which does not bring out facts which would be not only of interest but of value if the facts were recognized by the auditor and properly presented. Experience teaches that generally such information is gladly received. Scarcely ever, if ever, is it resented as presumptuous unless the engagement is so clear in its specifications as to preclude anything other than certain work. This, however, is rarely the case in an audit engagement.

A corporation organized under the laws of the State of Pennsylvania closed its books for the fiscal year and retained certified public accountants to make an audit of the accounts for the year. The balance sheet prepared by the auditors disclosed a substantial capital deficit. The income statement prepared by the auditors showed distributions of cash dividends sufficiently in excess of the profits for the current year and accumulations of prior years to produce the capital deficit. The dividends were equivalent to about 80 per cent. of the par value of capital stock outstanding. Dividends of 20 per cent. would have constituted an exceedingly liberal return on an investment in the line of business in question.

The Pennsylvania law permits such dividends out of net profits "as shall appear advisable to the directors" but such dividends shall in no case exceed the net profits "actually acquired" by the company so that by the distribution of dividends the capital of the company may become impaired. Directors who declare a dividend when a company is insolvent or the payment of which would render it insolvent become jointly and severally liable for all debts of the company to the extent of the dividend so declared.

In the case under discussion the directors rendered themselves liable in the amount of the capital deficit. They placed their reputation for sound business judgment in jeopardy by allowing the corporation to be deprived of funds which should not have been withdrawn.

The balance sheet showed that the amount due trade creditors was considerably in excess of the merchandise inventory. In addition, bank loans, all of one bank, equal to more than one-third of the current assets, had been increased $15,000 during the year and represented about 65 per cent. of the accounts receivable. The same bank also had discounted $80,000 of the company's notes receivable of customers.

Accounts receivable were only slightly in excess of one month's average sales but inventories were sufficient for only about half a month's average sales, a stock not only out of proportion to the turnover in the business in question but somewhat risky in the light of sources of supply, deliveries, and transportation emergencies.

The capital investment situation was also one calling for consideration. At the close of the previous year the capital supplied by outsiders (accounts, notes and loans payable, etc.) was 43 per cent. of the total, leaving 57 per cent. representing the equity of the proprietors. The balance sheet as of the date closing the audit period showed that the situation had changed so that 53 per cent. of the total capital was then being furnished by outsiders, with only 47 per cent. belonging to the proprietors. Of the capital contributed by outsiders, 60 per cent. was furnished by the bank, which contribution was equal to about one-third of the entire capital in the business.

This case is one typical of inefficient financial management. Sales for the year had shown a large increase, with a very satisfactory improvement in the ratio of cost to sales. Selling, administrative and general expenses had increased slightly, due to causes which were apparent and entirely proper. The increase in net profit from operations was substantial, both in amount and in relation to sales. Altogether the operating figures were indicative of a growing, healthy business. The cream, however, was being skimmed, inadvertently, but none the less quickly and too closely by the proprietors.

If, instead of the large amount which was distributed as cash dividends, funds in excess of rational dividend disbursements had been utilized in reducing the bank loans and trade liabilities, the capital deficit would have been avoided, the directors would have escaped personal liability, and the credit position of the company would have been much improved. One quarter of the profits for the year would have sufficed for liberal dividends. Had the remainder been applied in an efficient financial manner, the current assets would have been two and a half times the current liabilities instead of one and a third times, as they were. The bank would have had no occasion for calling the loans which, had it so done, the company could not have met out of funds in hand, the cash on deposit being equal to only 14 per cent. of the amount due to the bank.

In the light of the foregoing, note the comments of the auditors, which without mentioning any of the above, were in part as follows: "The cash on deposit at December 31, 1923, was verified by certifications of the depositaries. The office and salesmen's funds of $1,000 were verified by count on March 1, 1924. The notes and trade acceptances receivable at December 31, 1923, were verified by inspection of those on hand at the time of our audit, and by reference to correspondence, cash records, etc., for those discounted or collected prior to our audit. The detailed records of accounts receivable were examined and the aggregate amount of the balances therein at December 31, 1923, was found to be in agreement with the general ledger controlling account. During the year under review monthly amounts, based on volume of sales, were credited to a reserve account to provide for uncollectible accounts. All accounts which during the year under review proved to be uncollectible were charged against the reserve and the remaining balance at December 31, 1923, was transferred to profit and loss."

So the recital runs on for several pages. There is nothing about the business. It is all about the accounting methods and audit procedure. The financial statements are all that might be desired. They are well arranged and in comparative form. The story which has been related in illustration of the possibilities of interpretation and as offering a basis for useful comment was read out of the statements.

The argument may be advanced perhaps that if the situation as interpreted is shown by the statements the client can find the facts therein. Why then bring out something which is apparent? The answer is this: The client is not likely to associate the figures in the same manner as does the accountant. He probably will not see the undesirable capital tendencies until they are brought out for him. He probably will not realize the danger line which in fact he has already passed with respect to the bank. Service to clients is not complete, nor does the report fulfil its mission until the financial data which the statements contain are presented in a way which will leave no doubt as to their significance. Such reports are more likely to win the respect and satisfaction of clients than the other kind.